

ADVANTAGES FOR TAX-EXEMPT INVESTORS

The federal tax code prohibits tax-exempt institutional investors from leveraging income-generating investments through the use of debt. The penalty for violating the constraints is severe, potentially including loss of the tax-exempt status.

A cottage agency industry has developed in response that leverages leased real estate investments for tax-exempt institutions. Industry members purchase income-generating property, mortgage the property and sell the leveraged investment package to tax-exempt institutions.

This process doesn't seem to violate the tax code constraint, which doesn't apply to the purchase of property already leveraged with preexisting debt. However, informal cooperation between the institutions and the agents implied by the process is a source of uncertainty for tax-exempt investors about whether the process stretches the boundaries of the tax code constraint. As a result, many tax-exempt investors avoid this practice.

There is a better alternative. The tax code constrains tax-exempt investor use of debt, not the use of leverage. This was a distinction without a difference prior to the development of the synthetic debt capital structure. However, the tax code allows tax-exempt investors to leverage income-generating property if the leverage does not encumber the property with debt.

Synthetic debt finance creates the appropriate all-equity capital structure for leased property. The capital structure has two deeded equity components: a term of years interest and a remainder interest.

Neither interest has any claim against the other interest, and both interests are debt-free. This eliminates any need for independent agents to purchase and leverage leased property prior to acquisition by tax-exempt investors.

The term of years interest is a fixed-income asset. Since the synthetic debt capital structure divides the investment characteristics of unleveraged leased property between the two interests, the remainder interest inherits all non-fixed-income investment characteristics of the property.

Tax-exempt investors can create debt-free leverage for leased property by selling appropriately designed term of years interests. Since the term of years interests are fixed-income assets, the investors retain the portfolio diversification benefits of leased property investments with a significantly reduced capital commitment to the asset class.

Alternatively, the investors can take advantage of the leverage to make more debt-free acquisitions of leased property for the same amount of investment capital. This increases the diversification benefits of investing in leased property without reducing their available capital for other types of investments.

Flexibility is another advantage that accompanies the synthetic debt structure. Tax-exempt investors can use synthetic debt finance to reorganize the capital structure of directly owned property whenever their investment strategy deems it appropriate. This endows tax-exempt investors with flexibility in leased property investment planning undreamt of prior to development of the synthetic debt structure.

The synthetic debt capital structure should be attractive to tax-exempt institutions interested in commercial real estate investments but deterred by the extreme alternatives of unleveraged direct real estate ownership and indirect debt-encumbered ownership through REITs. The flexible alternatives offered by synthetic debt finance should be of particular interest to pension funds that are required by ERISA prudent diversification criteria to invest in commercial real estate.